ICAA

July 2, 2003

Via Electronic Mail

Judith R. Starr, Chief Counsel
Office of the Chief Counsel
Financial Crimes Enforcement Network
Department of the Treasury
P.O. Box 39
Vienna, Virginia 22183

Re: Section 352 Investment Adviser Rule Comments

Dear Ms. Starr:

The Investment Counsel Association of America[1] appreciates the opportunity to comment on the Department of Treasury Financial Crimes Enforcement Network's proposal[2] to require certain investment advisers that manage client assets to establish an anti-money laundering (AML) program pursuant to Section 352 of the USA Patriot Act.[3] Investment advisers covered by the Proposal would be required to establish an AML program that includes four minimum requirements: (i) the development of internal policies, procedures, and controls; (ii) the designation of a person or persons responsible for the AML program; (iii) an ongoing employee training program for appropriate persons; and (iv) independent testing of compliance. The proposed rule would also delegate FinCEN's authority to examine investment advisers for compliance with these requirements to the Securities and Exchange Commission (SEC).

The ICAA recognizes the importance of preventing and detecting international money laundering and the financing of terrorism. We strongly support Treasury's efforts to implement effective and flexible regulations to assist financial institutions in developing policies and procedures to detect and prevent the use of their facilities, products, and services by money launderers. Since the passage of the USA Patriot Act, the ICAA has engaged in a dialogue with officials from the Treasury, the SEC and other agencies to

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[1] The Investment Counsel Association of America is a not-for-profit organization that exclusively represents the interests of SEC-registered investment advisory firms. Founded in 1937, the ICAA today consists of about 300 federally registered advisory firms that collectively manage in excess of $3 trillion for a wide variety of individual and institutional clients. For more information about the Association, please see our Web site at www.icaa.org.

[2] Financial Crimes Enforcement Network (FinCEN); Anti-Money Laundering Programs for Investment Advisers, 68 Fed. Reg. 86 (May 5, 2003) (the "Proposal").

[3] Pub. L. No. 107-56, 115 Stat. 272 (2001) ("USA Patriot Act").

INVESTMENT COUNSEL ASSOCIATION OF AMERICA, INC.
1050 17TH STREET, N.W., SUITE 725 WASHINGTON, DC 20036-5503
(202) 293-ICAA FAX (202) 293-4223

discuss the application of such regulations for investment advisers. In particular, we shared our concern that aspects of the regulations may not be appropriate for advisers because of the nature of the investment advisory profession. We urged that any regulations covering investment advisers provide substantial flexibility, especially with respect to small advisers. We also suggested that advisers be able to rely on other financial institutions already subject to AML program requirements.

We are pleased that the regulations proposed by FinCEN have adopted a risk-based approach to AML compliance. Such an approach is essential to providing investment advisers the flexibility needed to tailor their AML efforts to fit the nature and scope of their business. We take this opportunity to discuss the practical implications of various aspects of the Proposal and recommend modifications appropriate to the characteristics of the advisory profession.

Background on the Investment Advisory Profession

In the traditional advisory model, the investment adviser provides continuous and regular supervision or management of its clients' securities portfolios based on a written contract executed by each client and the investment adviser. Investment advisers are usually compensated based on a percentage of assets under management, not on a transactional basis. This structure promotes a long-term relationship between client and adviser and helps to align the interests of the adviser with the client. Most of these advisers are given authority by their clients to manage their assets on a "discretionary" basis – that is, to make investment decisions on behalf of the client within the guidelines, needs, and objectives of the client without contacting the client for permission before each transaction.

The vast majority of advisory relationships are entered into to achieve long-term investment objectives. In order to implement a selected investment strategy that achieves these objectives, the portfolio manager needs to know that the assets will remain in the custodial account and that the client will not be withdrawing or depositing significant amounts that would interfere with the strategy.[4] Thus, it is unlikely that a person would deem a discretionary advisory relationship to be an attractive vehicle for money laundering.

One of the most important distinctions between investment advisers and other financial institutions is that investment advisers typically do not actually hold a client's assets or serve in a custodial capacity. Instead, the client or adviser selects a custodian – typically a bank or broker-dealer – to hold client funds and securities. The client opens an account with the custodian and authorizes the custodian to accept investment instructions from the adviser. The adviser typically does not have the opportunity to view how the client's account is funded or where withdrawals from the account are sent.[5]

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[4] *Cf. Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Unregistered Investment Companies*. 67 Fed. Reg. 187 at 60619 (September 26, 2002) (noting that entities requiring lengthy investment periods are less susceptible to money laundering).

[5] The adviser may have communications with the custodian regarding settlement problems or issues that arise during the reconciliation process. These communications, however, generally involve specific

Although the investment advisory profession manages in aggregate approximately $18 trillion in assets on a discretionary basis, the 274 largest investment advisory firms manage 80 percent of these assets.[6] As FinCEN recognizes, most investment advisory firms are relatively small in size with few employees: only ten percent of federally registered advisers reported having more than 50 employees, "whereas nearly half reported having one to five employees."[7] The clientele of SEC-registered advisers is also quite diverse, including individuals, banks, mutual funds, pension funds, hedge funds, charitable organizations, corporations, and state or municipal entities.

Discussion

I. Scope of Proposal

The Proposal notes that in some instances, investment advisers manage pooled investment vehicles that are themselves required to maintain AML programs under the Bank Secrecy Act (BSA) rules, such as mutual funds. In order to prevent overlap and redundancy, the Proposal would permit investment advisers to exclude from their AML programs "any [pooled] investment vehicle they advise that is subject to an anti-money laundering program requirement under BSA rules." The Proposal further explains that advisers may exclude pooled investment vehicles that are sponsored or administered by financial institutions.

The ICAA applauds FinCEN for adopting this approach to avoid unnecessary duplication of efforts among financial institutions. We note, however, that the actual text of the proposed rule does not clarify that the exclusion extends to pooled investment vehicles that are *sponsored or administered by financial institutions subject to BSA requirements*. We recommend that the final rules reflect this added language.

In addition, there are certain pooled investment vehicles that, although not subject to existing or proposed BSA program requirements, are not likely to pose a significant money laundering risk and therefore may be excluded entirely from the adviser's AML program. In the proposed AML program rules for unregistered investment companies, FinCEN expressly excludes the following companies from the definition of an "unregistered investment company" that would be subject to BSA rules: (1) companies that permit redemptions only after two years from the date of purchase and (2) companies that have total assets of less than $1,000,000 as of the most recently completed calendar quarter.[8] FinCEN has recognized that these types of companies are "not likely to be used

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trades initiated by the adviser and do not involve how the client's account is funded, where moneys are wired, or information about other accounts the client may have with the custodian. We understand that, in limited circumstances, some small advisers with individual clients may transmit withdrawal instructions from the client to the custodian as a courtesy to the client and thus would know where the money is transmitted in those instances.

[6] ICAA/NRS, *Evolution/Revolution: A Profile of the U.S. Investment Advisory Profession* (May 2003) at 3 ("Evolution/Revolution Report"). The vast majority of large investment advisory firms are associated with a broker-dealer, bank, or investment company and therefore already are dealing with AML issues.

[7] Proposal at 10; *see also* Evolution/Revolution Report at 4.

[8] *See* FinCEN; Anti-Money Laundering Programs for Unregistered Investment Companies, 67 Fed. Reg. 187 (September 26, 2002) at 60620.

by money launderers."[9] Similarly, we recommend that investment advisers be permitted to exclude these types of pooled investment vehicles from their AML program procedures.

Similarly, we recommend that investment advisers be afforded the same opportunity to exclude offshore funds located in FATF-compliant jurisdictions from their AML programs. An investment vehicle organized in a FATF-compliant jurisdiction is already subject to AML rules applicable to such vehicles. We submit that regulatory regimes that are consistent with FATF standards are substantially similar to the BSA regulatory structure.[10] There is no reason for an adviser to develop an additional layer of AML policies and procedures for these offshore funds.

II. Development of Policies and Procedures

An investment adviser subject to the Proposal would be required to develop and implement its own AML program reasonably designed to prevent the firm from being used to launder money or finance terrorist activities. Every AML program must incorporate four minimum requirements:

(i) the development of internal policies, procedures, and controls;
(ii) the designation of a person or persons responsible for implementing and monitoring the program;
(iii) an ongoing training program for appropriate persons; and
(iv) independent testing of compliance to be conducted internally or by an outside party.

As with other financial institutions subject to AML program requirements, the Proposal affirms that each adviser has the flexibility to tailor its program to fit its business, taking into account factors such as size, location, activities, and risks or vulnerabilities to money laundering. As noted in the Proposal, FinCEN expects that large firms will adopt detailed procedures and smaller firms may adopt procedures consistent with their simpler, centralized organizational structure. In fact, according to FinCEN, if an investment adviser is small, the burden to comply with the proposed rule should be *de minimis*.[11]

We are pleased that the proposed regulations recognize the broad diversity within the investment advisory profession and appropriately emphasize a risk-based approach to AML compliance. Such an approach offers investment advisers much needed flexibility to tailor their AML programs to fit their business needs and resources. We agree that a small

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[9] *Id.*

[10] *See also* Managed Funds Association Letter to FinCEN re: Section 352 Unregistered Investment Company Regulations (November 25, 2002) at 6 (urging FinCEN to permit delegation of AML responsibilities to third parties located in FATF-compliant jurisdictions); SIA Letter to U.S. Department of the Treasury re: Submission to Treasury Patriot Act Task Force (March 7, 2003) (urging FinCEN to permit reliance on intermediaries subject to AML requirements in FATF-member jurisdictions and jurisdictions with similar regulatory requirements).

[11] Proposal, Section VI, Regulatory Flexibility Act, at 20. The effectiveness of the AML rule will be enhanced, while reducing burdens and costs, to the extent that the Department and other federal agencies are able to adopt coordinated processes, such as establishing a single, centralized control list against which clients could be checked.

adviser should not be required to incur significant costs to comply with the proposed rule requirements. For example, a small adviser whose only clients are individuals with a pre-existing relationship with the adviser should require relatively minimal AML policies and procedures. Such an adviser may be able to develop procedures that simply reflect the firm's awareness of the risks of money laundering and a commitment to monitor for suspicious behavior.

Similarly, we concur with FinCEN's risk-based approach as it pertains to U.S. and non-U.S. pooled investment vehicles that are not subject to BSA requirements (subject to our comments in Section I of this letter). The Proposal notes that advisers providing investment advice to pooled investment vehicles that are created or administered by a third party must conduct an assessment of the money laundering risk posed by the particular vehicle or entity that created and administered the vehicle. In these circumstances, the adviser would need to establish procedures to assess whether the entity that created and administered the vehicle, or the nature of the vehicle itself, poses significant money laundering risks. As the potential vulnerability to money laundering increases, the procedures would need to address the increased risks. We seek confirmation, however, that in assessing the risk posed by U.S. and non-U.S. pooled investment vehicles, an adviser may treat such vehicles as the "client" and will not have an obligation to "look through" the pooled vehicle to obtain information about the underlying investors.[12]

We take this opportunity to address some concerns that we have with respect to the following matters: (1) suspicious activity guidance, (2) division of AML responsibilities among financial institutions, and (3) approval of the AML program.

A. Suspicious Activity Guidance

Currently, there is no regulatory guidance on what constitutes "suspicious activity" in the investment advisory context. In the proposing release, FinCEN provides examples of areas of suspicious activity for advisers. These examples, however, are more applicable to financial institutions that have access to client funds and securities, such as banks and broker-dealers. For example, FinCEN notes that advisers' procedures would identify unusual transactions upon the subsequent withdrawal of assets from management with the firm and transfers to unrelated accounts or to accounts in countries where drugs are produced. Most investment advisers do not receive information regarding such transactions and should not be required to have procedures to identify such transactions. In fact, advisers generally will not be able to monitor how customers fund their accounts, make wire transfers to high-risk countries, engage in unusual wire activity, or request transfers to third parties.[13] Rather, the custodian of the managed assets will have primary access to the information needed to assess whether there is suspicious activity in these areas.

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[12] We are concerned that the Proposal seems to suggest otherwise. *See* Proposal at 14 (stating "[a]s the entity's potential vulnerability to money laundering increases, the adviser's procedures would need to reasonably address these increased risks, such as by obtaining and reviewing information about the identity and transactions of the investors in the vehicle.").

[13] *See* Securities Industry Association, *Preliminary Guidance for Deterring Money Laundering Activity* (Feb. 2002).

The ICAA strongly recommends that FinCEN provide guidance regarding the types of suspicious activity that are most appropriate for investment advisory firms to monitor. We provide the following as examples of potential indicators of suspicious activity that may be relevant for investment advisers:[14]

- A client exhibits an unusual concern regarding the adviser's compliance with government reporting requirements or is reluctant or refuses to reveal any information concerning business activities, or furnishes unusual or suspect identification or business documents;
- A client appears to be acting as the agent for another entity but declines, evades, or is reluctant to provide any information in response to questions about that entity;
- A client's account has a pattern of inexplicable and unusual withdrawals, contrary to the client's stated investment objectives;
- A client requests that a transaction be processed in such a manner so as to avoid the adviser's normal documentation requirements; or
- A client exhibits a total lack of concern regarding performance returns or risk.

We recommend that FinCEN substitute the above-referenced potential indicators of suspicious activity for those in the Proposal. Of course, these potential "red flags" are not dispositive. An adviser's determination of whether the activity is actually an indicator of suspicious activity will necessarily depend on the facts and circumstances regarding the particular transaction, the client, and the client's relationship with the adviser.

B. <u>Division of AML Responsibilities Among Financial Institutions</u>

As FinCEN notes in the Proposal, advisory clients typically have relationships with other financial institutions, such as banks and broker-dealers that are already subject to AML program requirements. In such cases, the investment adviser should only be required to monitor activities of which it is aware and should not be required to gather additional AML information from such entities that it does not already receive in the ordinary course of business.[15] We are concerned that Footnote 22 of the Proposal appears to suggest that an investment adviser would have an obligation to "coordinate review" of transactions with the custodian in situations where the adviser selects and retains the account custodian. We do not believe that such an obligation is appropriate, particularly where an adviser's client accounts may be held at dozens of custodian firms. Even when the adviser selects the account custodian, the custodian still controls all account transaction information.

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14 *See, e.g.,* SIA Guidelines, at 12-13.

15 Of course, in the limited circumstances where an adviser becomes aware of information that may indicate suspicious activity, the adviser may rely on the information-sharing provisions of the USA Patriot Act to coordinate with other financial institutions to assess whether a money laundering risk is present. Section 314(b) of USA Patriot Act allows financial institutions, regulatory authorities, and law enforcement authorities to share information about suspicious activities. Section 314(b) applies to all financial institutions that are required to establish an AML program. We understand that upon adoption of final AML program rules for advisers, advisers will be treated as a "financial institution" for purposes of Section 314(b).

More importantly, the custodian, as a "financial institution," is subject to bank or broker-dealer AML rules. Instead of coordination, the obligation suggested by the footnote would result in duplication, contrary to FinCEN's stated purpose in developing the proposed rules. Similarly, an adviser that serves as one of many advisers to a particular client should only be required to monitor for account activity and respond to red flags that arise in the ordinary course of its own relationship with the client.

We suggest two additional relationships where an adviser's efforts would be duplicative of the AML efforts of other financial institutions. First, an adviser that provides subadvisory services to a registered investment adviser subject to BSA requirements (the "primary adviser") should not be required to include the subadvised clients of the primary adviser in its AML program.[16] The primary investment adviser will already have conducted due diligence regarding the clients and, for monitoring purposes, will have all of the relevant information that the subadviser may also have. Similarly, an adviser in a wrap account program should not be required to include the wrap account clients in its AML program. The sponsors of wrap programs are broker-dealers subject to BSA requirements and/or registered investment advisers that will be subject to BSA requirements. In these programs, the sponsor has the primary relationship with the clients, has already conducted know-your-customer procedures for these clients, and has the ability and obligation to monitor account activity. Advisers generally have little or no personal contact with wrap account clients and instead make the investment decisions for the client based on the suitability analysis conducted by the sponsor. Accordingly, there would be no value added by requiring advisers to conduct duplicate due diligence on these clients or to monitor the same transactions monitored by the sponsor.

By the same token, we recognize that with respect to individuals and institutions as to which an investment adviser has the primary relationship, the adviser should be responsible for knowing the client and monitoring of the type described above.

Finally, we understand that if an adviser retains a service provider or vendor to conduct part of its AML program (for example to gather information about clients or to review the adviser's documents to monitor for suspicious activity), the adviser retains responsibility for the effectiveness of the AML program and must take reasonable steps to assess the competency of the service provider to carry out the program. There has been some confusion in the industry, however, between the concept of "delegating" one's own AML functions to a service provider (and retaining ultimate responsibility) and "reliance" on the fact that other financial institutions subject to BSA requirements that share the same client with the adviser have already included that client in their AML program. In the latter situation, we seek confirmation that the adviser does not retain responsibility for the effectiveness of the AML program of other financial institutions and does not need to conduct due diligence on the financial institution's AML program.

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[16] Similar to our request in Section I regarding offshore pooled vehicles, we request that an adviser be permitted to rely on the AML efforts of advisers in FATF jurisdictions with respect to subadvised accounts in non-U.S. jurisdictions.

C. Approval of AML Program

The Proposal would require that each investment adviser's program be approved in writing by the board of directors or trustees or, if it does not have one, by its sole proprietor, general partner, or other persons who have similar functions. We concur with the intent to have high-level support within the firm for approval of the AML program. We note, however, that owners or principals are probably not the appropriate parties for program approval. We recommend instead that FinCEN's final rules permit approval by a member of senior management, consistent with the corresponding rules for broker-dealers.[17]

III. Designation of AML Officer

The Proposal requires that advisers designate a person (or group of individuals) responsible for implementing and monitoring the operations and internal controls of the AML program. The person or persons should be competent and knowledgeable regarding applicable requirements and money laundering risks. The ICAA supports this aspect of the Proposal but seeks clarification with respect to FinCEN's statement that "the person responsible for overall supervision of the AML program should be an officer of the investment adviser." We note that many advisers may not have "officers" *per se.* Instead, the final release should acknowledge that a person responsible for overall supervision of the AML program should be a member of senior management or report directly to senior management. This would ensure that the responsible person has adequate authority to oversee the program, while providing flexibility for a firm to appropriately structure its own operations.

IV. Independent Testing Function

The Proposal requires investment advisers to establish independent testing of the AML program to be conducted internally by employees of the advisory firm or by outside auditors. Personnel conducting the testing should have a working knowledge of applicable BSA requirements but should not be the person designed to implement or monitor the AML program. We applaud FinCEN for clarifying that the independent testing function is simply testing, and not necessarily a full-blown "audit" of the AML program.

Nevertheless, we are extremely concerned with the cost and burden of such a requirement, particularly for small advisers. Most investment advisory firms are relatively small in size with few employees. According to our most recent report, a total of 3,859 or 49 percent of federally registered advisers have only between one and five employees. Indeed, 5,299 or 67 percent of all SEC-registered advisers have ten or fewer employees.[18] The staffs of such advisers are not likely to include personnel who are knowledgeable regarding BSA requirements but are not already involved in implementing the AML program. Accordingly, it will be very difficult for these small firms to conduct a test internally under rigid definitions of independence. Perversely, the smallest firms that can

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[17] Proposed Rule Change by National Association of Securities Dealers, Inc., Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934, File No. SR-NASD-2002-24, at 18.

[18] Evolution/Revolution Report at 5.

least afford it will be the firms that need to hire outside consultants for an audit. The cost for an external audit could be significant, especially for small advisers. This is contrary to FinCEN's assumption that the Proposal will "not have a significant economic impact on a substantial number of small entities."[19]

Given that advisers typically do not hold client funds or assets, we suggest that the adopting release provide flexibility in this area.[20] For example, we seek confirmation that small advisers will be permitted to employ an internal testing regime that may include personnel involved in the firms' ongoing BSA compliance. In addition, we appreciate the flexibility provided in the Proposal regarding frequency of testing and seek confirmation that certain firms, such as those with a relatively stable client base, may reasonably choose to conduct testing on a less-than-annual basis, such as every two-three years.

V. Delegation of Compliance Enforcement to SEC

The Proposal notes that FinCEN has delegated examination authority to the SEC. The ICAA supports this delegation of authority because the SEC is the appropriate functional regulator for SEC-registered investment advisers. We anticipate that examination of AML compliance will be integrated into the SEC's general examination program.

VI. The Compliance Date and Related Issues

The Proposal requires an adviser to establish and implement its AML program within 90 days of adoption of the final rules. We are concerned that firms may have difficulty meeting this compliance date and request that the final rules allow for a longer compliance period.

The proposed rules impose new and significant responsibilities on advisers. The development and implementation of policies and procedures to ensure compliance with the new rules will be time-consuming. Depending on each firm's particular characteristics, investment advisers may have to change their advisory agreements and implement new operational and compliance procedures to comply with the proposed rules. In addition, advisers will have to spend a considerable amount of time training employees about BSA requirements. In some instances, especially for smaller firms that do not employ a full-time compliance officer, an adviser may have to spend significant time educating its compliance officer regarding BSA rules. Accordingly, we recommend that FinCEN allow an adviser to establish and implement its AML program within 180 days after final rules are adopted.

In addition, we understand that any new AML rules for investment advisers will have prospective application only; that is, advisers will not be required to implement

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[19] Proposal at 20.

[20] We note that the SEC does not require registered investment advisers to conduct an independent test of their policies and procedures. Instead, advisers have discretion to determine the frequency and manner in which to evaluate their procedures, subject to SEC inspection. Advisers typically internally review their policies and procedures periodically and on an ongoing basis to ensure compliance with SEC regulations.

know-your-customer procedures with respect to existing clients and will not be required to review transactions that had already occurred at the time of rule adoption. We respectfully request that a statement to that effect be included in the final rules.

Finally, we understand that the Treasury Department has created a task force to study the costs incurred by firms of complying with the new anti-money laundering rules of the USA Patriot Act. We strongly support Treasury's efforts to assess the costs and benefits of continuing AML compliance and we urge the Department to consider less restrictive requirements in the future in the absence of meaningful cost-benefit data.

Conclusion

We truly appreciate your consideration of our comments on this important Proposal. We trust that you will not hesitate to contact us if we may provide any additional information or assistance to you during this process.

Sincerely,

David G. Tittsworth
Executive Director

cc: Charles D. Klingman
Paul F. Roye